

Research Department
Federal Reserve
Bank of
San Francisco

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More Pressure on the Dollar?

The dollar has strengthened in recent months, but its average trade-weighted value remains nearly 6 percent below last September's level, and many analysts believe that it will be significantly lower by the end of the year. (The trade-weighted value represents the dollar's exchange rate against the currencies of the nation's major trading partners, weighted by their respective shares in U.S. foreign trade.) Some believe that continued large trade deficits cannot be financed without a further decline in the dollar's value. Others believe that the recent improvement is only a temporary phenomenon — caused by unusually large capital inflows this spring — and that a further decline can be expected whenever this support is withdrawn.

However, some market indicators point to a more optimistic conclusion, suggesting that the dollar will be moving practically sideways in coming months. In other words, the market — measuring the forward prices of the dollar — may already have discounted the more pessimistic factors in the outlook. In early June, the price of a dollar for delivery in six months, on average, was less than one percent below its current value.

Trade deficit

Some of the pessimism stems from our currently large trade deficit. The deficit was \$31.5 billion last year. It worsened substantially during the first quarter of this year, to a \$44.8-billion annual rate. However, the market recognizes that the higher first-quarter

deficit was partly due to special factors unlikely to be repeated, such as the U.S. coal strike and the rise in the cost of imports caused by the dollar's depreciation. The market generally expects — and there presently seems no reason to dispute the assessment — that the figures for the next three quarters will be significantly better, although many analysts recognize that this year's total deficit could be worse than last.

It thus seems unlikely that the trade deficit will further depress the dollar. After all, the worst of this year's red ink is probably behind us. Only if the market is wrong, and the trade deficit in coming months fails to decelerate from the first-quarter figure, is there apt to be substantial further pressure on the dollar from this source.

Financing the deficit

But can continued large trade deficits be financed without a further decline in the dollar? Some analysts claim that they cannot — that the exchange value of the dollar has been sustained in recent months only by abnormally large capital inflows. These inflows may have been due largely to "leads and lags" — to a sharp reversal of the short-term claims and liabilities associated with the financing of international trade. Incidentally, leads and lags always create problems for analysts because of their great volatility.

According to this pessimistic view, recent inflows have been caused by the unwinding of positions which were

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taken against the dollar during its earlier period of decline. Thus, the argument goes, the dollar will come under renewed pressure whenever these inflows taper off. The analysts holding this view tend to assume that capital inflows (particularly short-term inflows) may temporarily raise the value of a currency above the level that the market believes is tenable in the long run. More generally, they tend to assume — somewhat implausibly — that short-term capital flows can cause exchange rates to vary away from their long-run values.

Actually, if market participants believed that the value of the dollar would decline drastically over the next several months, they would have a substantial incentive to sell it now and buy foreign currency with the proceeds. In this way, they could avoid losses on the falling dollar — and indeed, could gain substantial profits on their foreign-currency purchases. The funds they have available for such operations potentially far exceed the amounts that central banks possess for intervention purposes. Furthermore, large institutions often can buy and sell foreign currencies for future delivery with very little margin; in this situation, they could count on very large potential gains from speculating on such a relatively “sure thing.”

Market information

For these reasons, exchange rates are likely to reflect all the market’s current information about their long-run values. Stated otherwise, obvious opportunities for significant speculative

profits usually are quickly eliminated. Thus, factors widely perceived as temporary are unlikely to have a substantial impact on the dollar’s value. For example, if it were really true that the dollar’s value was being pushed up by abnormally large capital inflows, then we would expect to see the dollar fall as those inflows subsided. Such a possibility would offer investors a substantial profit opportunity — one which, presumably, they would have long since exploited, leaving no room for further downward pressure from that source.

Similarly, exchange rates are likely to reflect all the market’s current information about the direction of the U.S. trade deficit. Much of that deficit can be attributed to the relatively stronger growth of the U.S. economy, because of its more rapid recovery from the 1974–75 recession. Consequently, the U.S. trade balance should improve substantially once, as seems likely, more normal growth rates eventually are attained both here and abroad.

Again, the evidence of recent years does not support the conventional wisdom about the relationship of short-term capital flows and exchange rates. Many analysts tend to believe that large capital inflows raise the value of the dollar, while large capital outflows lower its value. However, the expected pattern failed to materialize in nearly half of the 19 quarters from the adoption of floating rates in early 1973 through the end of last year. In nine quarters, the average value of the dollar fell when net short-

term capital inflows increased, or rose when inflows declined. (In two other quarters, the average value of the dollar was essentially unchanged.)

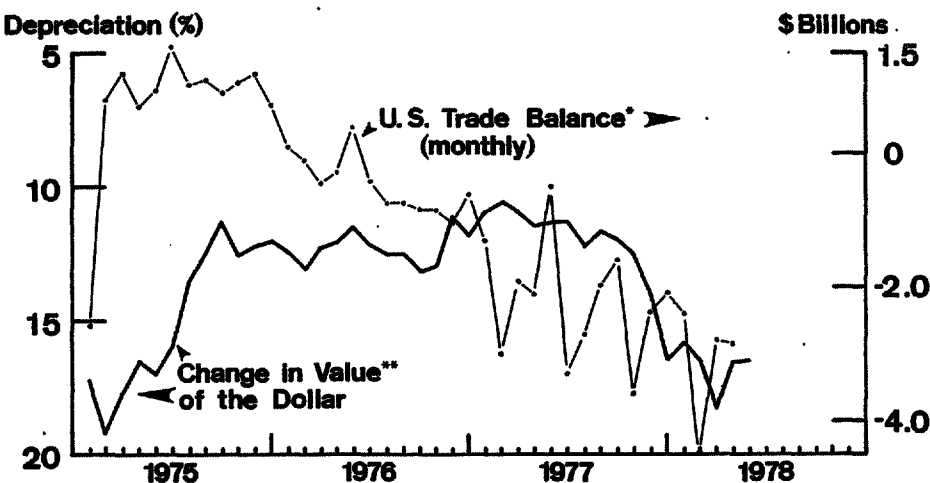
Effect, not cause

Indeed, recent experience suggests that large capital flows may not be a causal factor, but rather a result of other factors which change market expectations about the dollar and thereby lead to a change in its value. Last fall and winter's decline in the dollar may have largely reflected the fear that U.S. inflation was about to accelerate relative to abroad. Large capital outflows at that time would have reflected investors' attempts to reduce their holdings of a currency whose value was expected to decline — and the more re-

cent inflows would have reflected the market's belief that the opposite case was likely to develop in the period ahead.

On balance, these arguments would suggest that the dollar's value will not decline substantially in coming months. In this view, both last fall's decline in the dollar and its subsequent rise have been due to revisions in the comparative outlook for U.S. and foreign inflation. The market apparently now believes that the U.S. inflation will not worsen in late 1978 and 1979. If this belief is correct — a crucial assumption — then the dollar's exchange value may not worsen even in the face of a continued large trade deficit.

Charles Pigott



*U.S. exports (except military aid) minus U.S. general imports

**Change since May 1970 in dollar's exchange rate relative to eleven major trading partners, weighted by respective shares in U.S. foreign trade

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/7/78	Change from 5/31/78	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	113,265	+ 1,390	+ 14,691	+ 14.90
Loans (gross, adjusted)—total	90,779	+ 1,291	+ 15,014	+ 19.82
Security loans	2,902	+ 1,099	- 286	- 8.97
Commercial and industrial	27,583	- 152	+ 3,847	+ 16.21
Real estate	30,152	+ 76	+ 6,410	+ 27.00
Consumer instalment	15,805	+ 51	+ 3,114	+ 24.54
U.S. Treasury securities	8,233	+ 87	- 1,367	- 14.24
Other securities	14,253	+ 12	+ 1,044	+ 7.90
Deposits (less cash items)—total*	110,731	+ 1,763	+ 14,300	+ 14.83
Demand deposits (adjusted)	30,540	+ 1,479	+ 3,009	+ 10.93
U.S. Government deposits	268	+ 4	+ 66	+ 32.67
Time deposits—total*	78,071	+ 540	+ 11,151	+ 16.66
States and political subdivisions	6,962	- 77	+ 1,269	+ 22.29
Savings deposits	31,617	- 32	- 190	- 0.60
Other time deposits‡	36,389	+ 500	+ 8,916	+ 32.45
Large negotiable CD's	18,094	+ 496	+ 7,549	+ 71.59
Weekly Averages of Daily Figures	Week ended 6/7/78	Week ended 5/31/78	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves(+)/Deficiency (-)	+ 20	+ 24	+ 43	
Borrowings	37	254	5	
Net free(+)/Net borrowed (-)	- 17	- 229	38	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales(-)	+ 678	- 385	+ 496	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 565	+ 144	+ 562	

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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